Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Corbett | Analyst: Jeff Garnier | Bill Number: AB 10

Related Bills: See Legislative History | Telephone: 845-5322 | Amended Date: March 8, 2001

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Conformity/Real Estate Investment Trust

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

__X__ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO _____.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED _____. STILL APPLIES.

____ OTHER - See comments below.

SUMMARY

This bill would conform state law to the 1999 federal changes affecting real estate investment trusts (REITs).

SUMMARY OF AMENDMENT

The March 8, 2001, amendments removed all other provisions of the bill except the REIT provisions. The REIT provisions were analyzed in the department's previous December 4, 2000/February 6, 2001 analyses. For convenience, the REIT discussions from the previous analysis are being included in this analysis.

PURPOSE OF BILL

The purpose of the bill is to make California tax laws pertaining to REITs substantially the same as the changes made to federal laws affecting REITs in 1999 so that REITs operating in California can adopt the federal changes without losing their California REIT status.

EFFECTIVE/OPERATIVE DATE

As a tax levy this bill would be effective immediately. The changes proposed by this bill would be operative for taxable years beginning on or after January 1, 2001.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	03/19/01
____ N	____ OUA	__X__ PENDING		

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Income and Services Provided by Taxable REIT Subsidiaries

Federal law provides that a real estate investment trust (REIT) is an entity that receives most of its income from passive real-estate related investments and receives a dividends-received deduction to the extent of its income that is distributed to its shareholders. As a result, REITs generally pay little or no tax, instead the dividend recipients are generally subject to tax on the receipt of the dividend distributions.

If an electing entity meets the requirements for REIT status, the portion of its income that is distributed to its shareholders each year generally is taxed to the investors without being subjected to a tax at the REIT level (due to the dividends-received deduction received by the REIT). In general, a REIT must derive its income from passive sources and not engage in any active trade or business.

A REIT must satisfy a number of tests on a year by year basis that relate to the entity's (1) organizational structure; (2) source of income; (3) nature of assets; and (4) distribution of income. Under the source-of-income tests, at least 95% of its gross income generally must be derived from rents from real property, dividends, interest, and certain other passive sources (the “95% test”). In addition, at least 75% of its gross income generally must be from real estate sources, including rents from real property and interest on mortgages secured by real property. For purposes of the 95% and 75% tests, qualified income includes amounts received from certain “foreclosure property,” treated as such for three years after the property is acquired by the REIT in foreclosure after a default (or imminent default) on a lease of such property or on indebtedness that such property secured.

In general, for purposes of the 95% and 75% tests, rents from real property do not include amounts for services provided to tenants or for managing or operating real property. However, there are some exceptions. Qualified rents include amounts received for services that are “customarily furnished or rendered” in connection with the rental of real property, so long as the services are furnished through an independent contractor from whom the REIT does not derive any income. Conversely, amounts received for services that are not “customarily furnished or rendered” are not qualified rents.

An independent contractor is defined as a person who does not own, directly or indirectly, more than 35% of the shares of the REIT. Also, no more than 35% of the total shares of stock of an independent contractor (or of the interests in assets or net profits, if not a corporation) can be owned directly or indirectly by persons owning 35% or more of the interests in the REIT. In addition, a REIT cannot derive any income from an independent contractor.

Rents for certain personal property leased in connection with real property are treated as rents from real property if the adjusted basis of the personal property does not exceed 15% of the aggregate adjusted bases of the real and the personal property.

Rents from real property do not include amounts received from any corporation if the REIT owns 10% or more of the voting power or of the total number of shares of all classes of stock of such corporation. Similarly, in the case of other entities, rents are not qualified if the REIT owns 10% or more of the assets or net profits of such person.

At the close of each quarter of the taxable year, at least 75% of the value of total REIT assets must be represented by real estate assets, cash and cash items, and Government securities. Also, a REIT cannot own securities (other than Government securities and certain real estate assets) in an amount greater than 25% of the value of REIT assets. In addition, it cannot own securities of any one issuer representing more than 5% of the total value of REIT assets or more than 10% of the voting securities of any corporate issuer. Securities for purposes of these rules are defined by reference to the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-1 and following).

Under an exception to the ownership rule, a REIT is permitted to have a wholly owned subsidiary corporation, but the assets and items of income and deduction of such corporation are treated as those of the REIT, and thus can affect the annual qualification of the REIT under the income and asset tests.

A REIT generally is required to distribute at least 95% of its income before the end of its taxable year as deductible dividends paid to shareholders. This rule is similar to a rule for regulated investment companies (RICs) that requires distribution of at least 90% of its income. Both REITs and RICs can pay certain "deficiency dividends" after the close of the taxable year, and have these treated as made before the end of the year. The regulations applicable to REITs state that a distribution will be treated as a "deficiency dividend" (and, thus, as made before the end of the prior taxable year) only to the extent the earnings and profits for that year exceed the amount of distributions actually made during the taxable year.

A REIT that has been or has combined with a C corporation will be disqualified if, as of the end of its taxable year, it has accumulated earnings and profits from a non-REIT year. A similar rule applies to regulated investment companies (RICs). In the case of a REIT, any distribution made in order to comply with this requirement is treated as being paid first from pre-REIT accumulated earnings and profits. RICs do not have a similar ordering rule.

In the case of a RIC, any distribution made within a specified period after determination that the investment company did not qualify as a RIC for the taxable year will be treated as applying to the RIC for the non-RIC year, "for purposes of applying [the earnings and profits rule that forbids a RIC to have non-RIC earnings and profits] to subsequent taxable years." The REIT rules do not specify any particular separate treatment of distributions made after the end of the taxable year for purposes of the earnings and profits rule. Treasury regulations under the REIT provisions state that "distribution procedures similar to those for regulated investment companies apply to non-REIT earnings and profits of a real estate investment trust."

The Ticket to Work Act of 1999 (the "Act") made the following changes:

A. Investment limitations and taxable REIT subsidiaries

Under the provision, a REIT generally cannot own more than 10% of the total value of securities of a single issuer, in addition to the present law rule that a REIT cannot own more than 10% of the outstanding voting securities of a single issuer.

In addition, no more than 20% of the value of a REIT's assets can be represented by securities of the taxable REIT subsidiaries that are permitted under the Act.

Exception for safe-harbor debt

For purposes of the new 10% value test, securities are generally defined to exclude safe harbor debt owned by a REIT (as defined for purposes of IRC Sec. 1361(c)(5)(B)(i) and (ii)) if the issuer is an individual, or if the REIT (and any taxable REIT subsidiary of such REIT) owns no other securities of the issuer. However, in the case of a REIT that owns securities of a partnership, safe harbor debt is excluded from the definition of securities only if the REIT owns at least 20% or more of the profits interest in the partnership. The purpose of the partnership rule requiring a 20% profits interest is to assure that if the partnership produces income that would be disqualified income to the REIT, the REIT will be treated as receiving a significant portion of that income directly through its partnership interest, even though it also may derive qualified interest income through its safe harbor debt interest.

Exception for taxable REIT subsidiaries

An exception to the limitations on ownership of securities of a single issuer applies in the case of a "taxable REIT subsidiary" that meets certain requirements. To qualify as a taxable REIT subsidiary, both the REIT and the subsidiary corporation must join in an election. In addition, any corporation (other than a REIT or a qualified REIT subsidiary under IRC Sec. 856(i) that does not properly elect with the REIT to be a taxable REIT subsidiary) that a taxable REIT subsidiary owns, directly or indirectly, more than 35% of the vote or value is automatically treated as a taxable REIT subsidiary.

Securities (as defined in the Investment Company Act of 1940) of taxable REIT subsidiaries could not exceed 20% of the total value of a REIT's assets.

A taxable REIT subsidiary can engage in certain business activities that under prior law could disqualify the REIT because, but for the Act, the taxable REIT subsidiary's activities and relationship with the REIT could prevent certain income from qualifying as rents from real property. Specifically, the subsidiary can provide services to tenants of REIT property (even if such services were not considered services customarily furnished in connection with the rental of real property), and can manage or operate properties, generally for third parties, without causing amounts received or accrued directly or indirectly by the REIT for such activities to fail to be treated as rents from real property.

However, rents paid to a REIT generally are not qualified rents if the REIT owns more than 10% of the value (as well as of the vote) of a corporation paying the rents. The only exceptions are for rents that are paid by taxable REIT subsidiaries and that also meet a limited rental exception (where 90% of space is leased to third parties at comparable rents) and an exception for rents from certain lodging facilities (operated by an independent contractor).

However, the subsidiary cannot directly or indirectly operate or manage a lodging or healthcare facility. Nevertheless, it can lease a qualified lodging facility (e.g., a hotel) from the REIT (provided no gambling revenues were derived by the hotel or on its premises), and the rents paid are treated as rents from real property, so long as the lodging facility was operated by an independent contractor for a fee. The subsidiary can bear all expenses of operating the facility and receive all the net revenues, minus the independent contractor's fee.

For purposes of the rule that an independent contractor may operate a qualified lodging facility, an independent contractor will qualify so long as, at the time it enters into the management agreement with the taxable REIT subsidiary, it is actively engaged in the trade or business of operating qualified lodging facilities for any person who is not related to the REIT or the taxable REIT subsidiary. The REIT may receive income from such an independent contractor with respect to certain pre-existing leases.

Also, the subsidiary generally cannot provide to any person rights to any brand name under which hotels or health care facilities are operated. An exception applies to rights provided to an independent contractor to operate or manage a lodging facility, if the rights are held by the subsidiary as licensee or franchisee, and the lodging facility is owned by the subsidiary or leased to it by the REIT.

Interest paid by a taxable REIT subsidiary to the related REIT is subject to the earnings stripping rules of IRC Sec. 163(j). Thus the taxable REIT subsidiary cannot deduct interest in any year that would exceed 50% of the subsidiary's adjusted gross income.

If any amount of interest, rent, or other deductions of the taxable REIT subsidiary for amounts paid to the REIT is determined to be other than at arm's length (“redetermined” items), an excise tax of 100% is imposed on the portion that was excessive. “Safe harbors” are provided for certain rental payments where (1) the amounts are de minimis, (2) there is specified evidence that charges to unrelated parties are substantially comparable, (3) certain charges for services from the taxable REIT subsidiary are separately stated, or (4) the subsidiary's gross income from the service is not less than 150% of the subsidiary's direct cost in furnishing the service.

In determining whether rents are arm's length rents, the fact that such rents do not meet the requirements of the specified safe harbors shall not be taken into account. In addition, rent received by a REIT shall not fail to qualify as rents from real property by reason of the fact that all or any portion of such rent is redetermined for purposes of the excise tax.

Under the Act, the Treasury Department is directed to conduct a study to determine how many taxable REIT subsidiaries are in existence and the aggregate amount of taxes paid by such subsidiaries and shall submit a report to the Congress describing the results of such study.

B. Health Care REITs

The Act permits a REIT to own and operate a health care facility for at least two years, and treat it as permitted “foreclosure” property, if the facility is acquired by the termination or expiration of a lease of the property. Extensions of the two-year period can be granted.

C. Conformity with regulated investment company rules

Under the Act, the REIT distribution requirements are modified to conform to the rules for regulated investment companies. Specifically, a REIT is required to distribute only 90%, rather than 95%, of its income.

D. Definition of independent contractor

If any class of stock of the REIT or the person being tested as an independent contractor is regularly traded on an established securities market, only persons who directly or indirectly own 5% or more of such class of stock shall be counted in determining whether the 35% ownership limitations have been exceeded.

E. Modification of earnings and profits rules for REITs

The Act clarifies the REIT earnings and profits ordering rules in the case of a distribution to meet the requirements that there be no non-REIT earnings and profits in any year.

REIT earnings and profits rules are modified to provide a more specific ordering rule. The new ordering rule treats a distribution to meet the requirement of no non-REIT earnings and profits as coming, on a first-in, first-out basis, from earnings and profits that, if not distributed, would result in a failure to meet such requirement. Thus, such earnings and profits are deemed distributed first from earnings and profits that would cause such a failure, starting with the earliest REIT year for which such failure would occur.

F. Rental income from certain personal property

The Act modifies the present law rule that permits certain rents from personal property to be treated as real estate rental income if such personal property does not exceed 15% of the aggregate of real and personal property. The provision replaces the present law comparison of the adjusted bases of properties with a comparison based on fair market values.

G. Federal effective date and transition rules

The Act is generally effective for federal purposes for taxable years beginning after December 31, 2000. The provision with respect to modification of earnings and profits rules is effective for distributions after December 31, 2000.

In the case of the Act's provisions relating to permitted ownership of securities of an issuer, special transition rules apply. The new rules forbidding a REIT to own more than 10% of the value of securities of a single issuer do not apply to a REIT with respect to securities held directly or indirectly by such REIT on July 12, 1999, or acquired pursuant to the terms of written binding contract in effect on that date and at all times thereafter until the acquisition.

Also, securities received in a tax-free exchange or reorganization, with respect to or in exchange for such grandfathered securities, would be grandfathered. The grandfathering of such securities ceases to apply if the REIT acquires additional securities of that issuer after that date, other than pursuant to a binding contract in effect on that date and at all times thereafter, or in a reorganization with another corporation the securities of which are grandfathered.

This transition rule also ceases to apply to securities of a corporation as of the first day after July 12, 1999, on which such corporation engages in a substantial new line of business, or acquires any substantial asset, other than pursuant to a binding contract in effect on such date and at all times thereafter, or in a reorganization or transaction in which gain or loss is not recognized by reason of IRC Sec. 1031 or 1033. If a corporation makes an election to become a taxable REIT subsidiary, effective before January 1, 2004, and at a time when the REIT's ownership is grandfathered under these rules, the election is treated as a reorganization under IRC Sec. 368(a)(1)(A).

The new 10% of value limitation for purposes of defining qualified rents is effective for taxable years beginning after December 31, 2000. There is an exception for rents paid under a lease or pursuant to a binding contract in effect on July 12, 1999, and at all times thereafter.

Current state law conforms to the federal treatment of RICs and REITs with certain modifications.

The California modifications are:

- REIT taxable income does:
  - not include a deduction for dividends received,
  - not include a deduction for the tax imposed for not meeting the 95% or 75% income test,
  - include income from foreclosure property, and
  - include income from prohibited transactions.

- Federal excise taxes on “income from foreclosed property," “income of a prohibited transaction," “alternative tax on capital gains,” and failure to meet the 95% or 75% income test, do not apply.

- A REIT is subject to the corporate minimum franchise tax (currently $800).

- A REIT cannot be part of a stapled group.

Additionally, to avoid other state and federal law differences as to whether a REIT will qualify as such for state purposes, California has a rule whereby if the REIT satisfies the distribution requirements of federal law so as to be treated as a REIT, it will be deemed to satisfy such requirements for state purposes (even if federal-state REIT income differences make it otherwise impossible for the REIT to satisfy the distribution requirements for state purposes).

<u>Modify Estimated Tax Rules for Closely Held REITs</u>

If a person has a direct interest or a partnership interest in income-producing assets (such as securities generally, or mortgages) that produce income throughout the year, that person's estimated tax payments must reflect the quarterly amounts expected from the asset.

However, a dividend distribution of earnings from a REIT is considered for estimated tax purposes when the dividend is paid. Some corporations have established closely held REITs that hold property (e.g., mortgages) that if held directly by the controlling entity would produce income throughout the year. The REIT may make a single distribution for the year, timed such that it need not be taken into account under the estimated tax rules as early as would be the case if the assets were directly held by the controlling entity. The controlling entity is thus able to defer the payment of estimated taxes.

The Act provides that in the case of a REIT that is closely held, any person subject to the corporate estimated tax rules owning at least 10% of the vote or value of the REIT is required to accelerate the recognition of year-end dividends attributable to the closely held REIT, for purposes of such person's estimated tax payments due on or after December 15, 1999.

A closely held REIT is defined as one in which at least 50% of the vote or value is owned by five or fewer persons. Attribution rules apply to determine ownership.

The Act further provides that no inference is intended regarding the treatment of any transaction prior to the effective date.

Current state law does not contain any similar corporate estimated tax provisions that would require owners of a closely held REIT to accelerate the recognition of REIT dividends for estimated tax purposes.

THIS BILL

This bill would conform to the 1999 federal qualification provisions except that no excise tax would be imposed. The effective date will be the same for California as it is for federal purposes (i.e., for taxable years beginning after December 31, 2000). The provision with respect to modification of the earnings and profits rules would be effective for distributions after December 31, 2000, the same date as under federal law. California also would conform to the federal transition rules. In addition, this bill makes qualification as a California REIT dependent upon qualification as a federal REIT for the taxable year with no separate state election allowed, and makes a qualified federal REIT a qualified state REIT for the same taxable year.

This bill would conform to the new federal rule that accelerates the recognition of year-end dividends attributable to the closely held REIT for estimated tax purposes under the AFITL for B&CTL taxpayers. These estimated tax changes are made effective for estimated tax payments due on or after January 1, 2001.

LEGISLATIVE HISTORY

The provisions contained in this bill were contained in the Conformity Act of 2000, AB 2763 (Knox, 1999/2000). AB 2763 was held in the Assembly Appropriations Committee.

OTHER STATES' INFORMATION

Review of Florida, Illinois, Michigan, Minnesota, and New York tax systems indicate that they do not recognize REITs as a special entity and tax REITs as any other general corporation.

These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

This bill would have the following revenue effect:

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 2000 Enactment Assumed After June 30, 2001 $ Millions		
2000-01	2001-02	2002-03
$1	$4	$2

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue estimates were based on federal projections for Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170).

ARGUMENTS/POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for taxpayers, particularly when dealing with complex areas such as REITs. This is particularly true with respect to specialized entities such as REITs, since they are generally desirous of being treated as a REIT for both federal and California purposes, rather than being a REIT for federal, but not state purposes, or vice versa. In addition, absent conformity to these provisions under this bill, the greater operational flexibility rules added by the Ticket to Work Act of 1999 cannot be effectively used by REITs operating in California without jeopardizing their ability to continue to be treated as REITs for California purposes, thereby effectively resulting in those entities having to choose between not using the more flexible operating rules or losing their California REIT status. Finally, conformity also eases FTB's administration of the law by utilizing many federal forms, instructions, and precedential decisions. This bill conforms to the 1999 federal law changes that affect REITs.

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